Written Testimony of Eric S. Poe, Esq. CPA and Chief Operating Officer of CURE Auto Insurance before the Subcommittee on Oversight and Investigations, House Committee on Financial Services U.S. House of Representatives May 21, 2008

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify today on issues related to the proposed bill to ban the use of credit scores for auto insurance. This is an important issue for the U.S. private passenger automobile insurance industry, which is my company's industry, and I appreciate your interest.

I am the Chief Operating Officer of CURE auto insurance, a regional auto insurance headquartered in Princeton, New Jersey. CURE is licensed to write private passenger auto insurance in both Pennsylvania and New Jersey. We were founded in 1990 and currently rank as the 4th largest direct writer for auto insurance in New Jersey.

Prior to 2003, New Jersey auto insurers were not approved to use credit scores, education level, professional occupation, or homeownership status as factors in our rating or underwriting. However, in 2003, New Jersey's desire to attract several new national auto insurers into its marketplace led the regulators to permit these rating factors.[1] It was during this time that CURE analyzed these underwriting methods to determine their validity.

After significant review, CURE auto insurance determined that while these rating and underwriting variables do correlate to loss ratios, they merely serve as a statistical proxy for income. CURE does not employ these factors in its rates or underwriting. However, we will soon be compelled for competitive purposes, to adopt the practice or face losing our more profitable risks to competitors who utilize these factors.

[1]New Jersey Citizen Action. 2007. "Risky & Wrong: NJ Auto Insurance Rates for Lower Income and Minority Drivers Detailing the Discriminatory Price Impact of GEICO's Use of Occupation and Education in Determining Auto Insurance Rates for NJ Drivers." http://www.njcitizenaction.org\crapress2007feb28.html (accessed May 18, 2008).

INTRODUCTION

It is well documented that the auto insurance industry has used illustrations of loss ratio models as justification for using an individual's credit score,[2] education level and professional occupation.[3] By showing statistical correlations of these characteristic traits to corresponding loss ratios, the industry has effectively validated the concept that these factors, in fact, measure risk. However, I believe it is important to clarify, more carefully, the term "loss ratio" used by the insurance industry in these reports. By definition, a loss ratio is the incurred losses and loss-adjustment expenses divided by net earned premium. Stated simply, it is the costs associated with claim losses for the group in ratio to how much was collected in premiums for insuring that particular group. It is important to understand that loss ratio correlations used in this fashion are really used to measure rate adequacy for that particular group, not necessarily their predictive value to risk.

Surprisingly, our examination of the studies done relating to credit scores, education level and professional occupation led us to the opinion that an inappropriate conclusion had been drawn. The inappropriate conclusion found in each of these reports was that when a strong statistical correlation was found related to a given rating variable it was concluded that the rating variable therefore must have a predictive value for risk.[4]

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[2] Federal Trade Commission. 2007. "Credit-Based Insurance Scores: Impact on Consumers of Automobile Insurance." http: //www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf, footnote. 37, p. 21. (accessed May 18, 2008). Originally published in Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC (June 2003) [hereinafter EPIC Study]", available at http://www.progressive.com/shop/EPIC_CreditScores.pdf

[3] State of New Jersey Department of Banking & Insurance. 2008. "The Use of Occupation and Education Factors in Automobile Insurance." http://www.state.nj.us/dobi/division_insurance/ed_occ.html (accessed on My 18, 2008).

[4] Federal Trade Commission. 2007. "Credit-Based Insurance Scores: Impact on Consumers of Automobile Insurance." http: //www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf (accessed May 18, 2008). Originally published in Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger

However, it is important to understand an infinite number of characteristic traits may show correlations to loss ratios, but these loss ratio correlations will become invalid if they can be explained by another more valid characteristic trait imbedded in the chosen variable.

For example, in 2006 a comprehensive study of more than 15 million policyholders and two million claims showed that individuals who live within one mile of a restaurant, car dealer, elementary school, or liquor store would have an increased likelihood of filing a physical damage claim with their auto insurer for their car as opposed to those who did not. The study showed that the increase in loss costs for people who lived within a mile of those establishments were between 18-30% higher than those who did not.[5] From a cursory glance it appears that this data would actuarially justify the ability for auto insurers to class drivers who live within one mile of these particular businesses and charge them a higher rate.

However, because lower income individuals are more commonly found to be over-represented in urban areas which typically have their residences within one mile of a restaurant, car dealer, elementary school, or liquor store, it may be the imbedded characteristic trait of a person's income that, in fact, causes this loss ratio correlation. While merely living within one mile of these businesses does not logically cause someone to be a higher risk, it is reasonable to conclude that for a claim of small value lower income drivers are more likely to file a claim with their auto insurer while a higher income driver will forgo filing it all together.

In summary, if one assumes that the income of an individual is not properly accounted for by other risk factors already used in determining rates for car insurance, then these lower income drivers will in-fact produce higher loss ratios,

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Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC (June 2003) [hereinafter EPIC Study]", available at http://www.progressive.com/shop/EPIC_CreditScores.pdf.

[5] Quality Planning Corporation. 2005. "Why People Who Live Close to Restaurants Are More Likely To Have an Accident and Pay More for Auto Insurance Quality Planning Corporation." http://www.qualityplanning.com/qpc_resources_public/news/051206%20QPC%20Locations_F.htm (accessed on May 18, 2008).

and you would see a loss ratio correlation to income. More importantly, any characteristic trait that is tied to income will logically also produces similar loss ratio correlations given this assumption.

It is our belief that our fellow industry members would rather disguise to the public policymakers and regulators that these rating variables of individuals possess an unexplainable commonality that produces a correlation to risk. This is in light of the fact that all of these variables are correlated to income, and it is income that is correlated to risk.

USE OF CREDIT (INSURANCE) SCORES BY THE AUTO INSURANCE INDUSTRY

Tracking the history of the FICO credit score and its current use of three main credit bureaus today, it is clear that the original purpose behind the credit scoring system was to predict the likelihood of a person repaying debts on time and repaying the original loan.[6] We concluded through our analysis that while credit scores by the credit reporting agency did produce a correlation to loss ratios when applied to our own company data, there appeared to be strong evidence to support that the loss ratio correlations could be explained by an alternative variable – the income of an individual. This conclusion was drawn when we learned that an individual's prior on-time payment history to their creditors only constituted approximately 35% of their overall FICO/credit score,[7] while the category of credit utilization (outstanding balances to available credit) constitutes for approximately 30% of their total FICO score.[8] Due to the fact that credit lines offered by lenders are directly calculated upon a borrower's income and the scoring model reduced a person's credit score significantly based on the

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[6] Wozniacka, Malgorzata and Snigdha Sen. 2004. "Credit Scores – What You Should Know About Your Own." http://www.pbs.org/wgbh/pages/frontline/shows/credit/more/scores.html (accessed on May 18, 2008).
[7] myFICO. "What's In Your FICO Score." http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx (accessed on May 19, 2008).
[8] myFICO. "What's In Your FICO Score." http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx (accessed on May 19, 2008).

consumer's outstanding debt to their granted credit line, we concluded that credit scores used in this fashion is a strong predictor of a person's income.

Illustration of Impact of Income on FICO Credit Score: Based on annual gross income disclosed on a credit application, a low income individual is granted a $1,000 credit line, while similarly a high income earner is granted a $20,000 credit line with a credit card lender. Assumption: both individuals purchase $800 of groceries for the month on their credit card. If a FICO credit score is calculated during the time when the balance is $800, the negative impact to the lower income individual is far greater because their credit utilization is 80% compared to the higher income individual whose credit utilization is 4%. [the lower income person's credit score will have their credit score lowered significantly due to their excessive credit utilization ($800 of $1,000 available credit= 80% credit utilization) while the impact on the higher income individual's credit score is negligible ($800 of $20,000 available credit = 4% credit utilization).][9]

In fact, the 2007 Federal Trade Commission (FTC) study which examined the impacts of credit scoring on race shows that the same population negatively affected by the use of credit scores is the same ethnic groups who comprise of the lowest income earners according to the U.S. Census. These reported findings provided more support to our conclusion that an individual's income does correlate to loss ratio.[10]

[9] Simon, Jeremy. 2007. "Boost your credit score by raising your credit card limit." http://www.creditcards.com/credit-card-news/boost-credit-score-raise-credit-card-limits-1267.php (accessed May 19, 2008).

[10] Subcommittee on Oversight and Investigations House Committee on Financial Services. "Prepared statement of the Federal Trade Commission on Credit-based Insurance Scores: Are They Fair?" October 2, 2007, p. 6.

WHY AUTO INSURERS WANT TO ATTRACT AND INSURE HIGHER INCOME DRIVERS

Higher income drivers are more attractive to the private passenger auto insurance industry for several reasons: (A) a larger potential revenue stream for other products, (B) data mining, and (C) higher absorption of lower level claims.

A. POTENTIAL REVENUE STREAMS

Higher income drivers offer a larger revenue stream to auto insurers because they have the ability to purchase other products from multi-line insurance carriers such as GEICO, American Express, Liberty Mutual, State Farm, Allstate and Progressive.

Generally, lower income individuals' most significant assets are their automobiles.[11] The lower income population is not likely to own a home,[12] own a boat, they are unlikely to purchase financial planning services, need large life insurance policies, and don't have any need to purchase umbrella policies. Therefore, the lower income population provides no other potential revenue streams for multi-line insurance companies making them less attractive to insure.

B. DATA MINING

Auto insurers desire higher income drivers for data mining purposes as well. For example, at GEICO.com, despite clear statements to their users that they don't sell any information provided to their company for a quote, when one agrees to

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[11] According to a 2002 Pew Hispanic Center 25% of Latinos owned no assets other than a vehicle or unsecured liabilities as compared to 6% of Whites. Eric Rodriguez, "Credit-based Insurance Scoring: Why Latinos Pay More for Auto Insurance Than They Should." National Council of La Raza, October 2, 2007, p. 3.

[12] 2007 only half of Latino households own their own homes compared to more than three-quarters of non-Hispanic Whites. Eric Rodriguez, Credit-based Insurance Scoring: Why Latinos Pay More for Auto Insurance than They Should." National Council of La Raza, October 2, 2007, p. 3.

the terms and conditions for use of their highly advertised website they also agree to permit GEICO to share their information with any of their "marketing partners."[13] Data mining the information of high income individuals is a very lucrative business. Although it is not widely known to the public, many national data mining companies purchase information files from the majority of auto insurers which contain information regarding a person's credit score, their occupation, education level, their cars and where they live.[14] More troubling is the trend by auto insurers to run "reverse credit scores" without the submission of an applicant's social security number by using their name and address to look up their credit information on the credit reporting agency database. Although the user may consent to the terms and conditions of the insurers website for credit reports to be conducted, it is our contention that an individual who purposefully does not submit a social security number has no awareness that this reverse credit report is being searched and shared with other marketing partners.

C. HIGHER ABSORPTION OF LOWER LEVEL CLAIMS

The National Highway and Safety Association reported in 2000 that roughly half of all PDO (property damage only) accidents go unreported each year[15] "due to concerns about insurance or legal repercussions." Unfortunately, only certain individuals with higher income levels have the luxury of not reporting accidents and paying for the damage themselves.

As a result, higher income drivers are more attractive to the auto insurance industry because higher income driver's have the option to absorb minor claims

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13 http://www.geico.com/about/terms-of-use. (accessed on May 15, 2008).

14 Delaney, Kevin J., and Emily Steel. 2007. Firm Mines Offline Data to Target Online Ads. *The Wall Street Journal online*, October 17: B1.

15 National Highway Traffic Safety Association. 2002. "Economic Impact of U.S. Motor Vehicle Crashes Reaches $230.6 billion,NewNHTSAStudyShows."http://www.nhtsa.com/portal/site/nhtsa/template.MAXIMIZE/menuitem.f2217bee37fb302f6d7c121046108a0c/?javax.portlet.tpst=1e51531b2220b0f8ea14201046108a0c_ws_MX&javax.portlet.prp_1e51531b2220b0f8ea14201046108a0c_viewID=detail_view&itemID=2d673e37bdd9ff00VgnVCM1000002c567798RCRD&pressReleaseYearSelect=2002 (accessed on May 18, 2008).

out of their own pocket as opposed to filing a claim with the insurance company following an accident.

Therefore, it is reasonable to assume that the people who make less are more likely to file claims.[16] As a result, loss ratios on policies most likely will correlate to income as well as any characteristic trait that correlates to income. This is the reason why credit scoring, educational attainment, high income occupations and home ownership status, which all correlate to income, will have similar correlations to loss ratios.

INDUSTRY PRACTICES OF MULTI-AFFILIATED COMPANIES

Unbeknownst to consumers, most multi-state, multi-line auto insurance carriers have more than one company filed with each respective state that they are licensed to write. These multiple affiliate companies all bear the familiar trademark name of the company which leads consumers to believe they are only one entity.

Large group affiliate auto insurance companies have been successful at drawing a distinction between "underwriting" and "rating" of polices[17] when ultimately deriving the price to charge a consumer for auto insurance. The "underwriting" process begins when the multi-affiliate group assigns placement eligibility into one of the companies based upon a person's certain characteristic trait, while the "rating" process is when the insurance company uses the rates filed within that affiliate company to determine the final premium to be charged. Despite these

[16] Supported in the FTC 2007 study Fig 3, that shows that the correlation to loss ratios are stronger for collision claims, and weaker for bodily injury liability claims.

[17] Federal Trade Commission. 2007. Credit-Based Insurance Scores: Impact on Consumers of Automobile Insurance. http: //www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf. (p.16) (accessed May 18, 2008). Originally published in Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC (June 2003) [hereinafter EPIC Study]", available at http://www.progressive.com/shop/EPIC_CreditScores.pdf.

distinctions, it is important for the committee to understand whether you term a variable an “underwriting” variable or a “rating” variable either way they will each have drastic impacts on the ultimate premium charged to an individual.

GEICO’s USE OF EDUCATION AND OCCUPATION FOR “UNDERWRITING”

During our analysis of the competitive marketplace in 2004, we learned that GEICO’s ratemaking practices are threaded through its use of up to four separate GEICO insurance companies – GEICO, GEICO General, GEICO Indemnity and GEICO Casualty. The use of GEICO to bear the same trademark name, allows them to provide consumers the illusion that they are insured by one entity. However this is not the case as each GEICO affiliate company charges entirely different rates for the same coverages. Drivers qualifying for GEICO’s preferred insurance company receive the best (lowest) rates, while drivers who do not quality for GEICO’s preferred company receive rates from one of GEICO’s substandard insurance companies and pay substantially higher rates. Having up to four separate companies to underwrite drivers and four distinct and separate rates associated with each company, GEICO is capable of charging drivers that possess the same rating variables and coverage completely different rates based upon their “underwriting” variable of an individual’s education level and professional occupation. Remember, factors such as driving record, geographic location and car type are taken into account only after a consumer is placed in one of GEICO’s four companies through this process.

Drivers who possess higher educational attainments and hold white collar occupations are provided eligibility into the preferred GEICO Company. Conversely, individuals without a 4-year degree and “blue collar” nonprofessional jobs are typically only offered insurance through one of GEICO’s sub-standard companies and provided significantly higher rates.

Most notable, individuals are not even informed when they are rejected by the preferred GEICO Company based solely on their education and/or occupation. By purposefully failing to notify applicants of their rejection from the preferred GEICO Company due to

their lack of education or professional occupation, GEICO effectively bypasses any public scrutiny of its practice, which places an even larger burden on the legislature to protect the consumer from this practice.

Our comprehensive examination of GEICO's underwriting practices led us to conclude that the only clear homogeneous characteristic traits common among these preferred occupational groups are the traditional higher income levels associated with their occupations, further supporting our conclusion that income is truly the driver of loss ratio correlation and profitability for the GEICO Group of Companies.

ALLSTATE'S USE OF HOME OWNERSHIP STATUS AS AN "UNDERWRITING VARIABLE" AND ITS IMPACT ON RACE

A review of Allstate's recent filings suggests that regardless of driving record, an individual will not be eligible for their "preferred" company with their lowest rates if they don't own a home. Such evidence once again supports the contention that higher income earners produce correlations to loss ratios and profitability. Unfortunately the result of employing such underwriting rules tied only to homeownership status, is that certain minority groups and income classes are under-represented in the homeownership population in the United States.[18]

CONCLUSION

We believe the issue before the committee can be narrowly isolated to a question of public policy. Unlike other traditional business industries, it should be noted that auto liability insurance is mandated in the vast majority of the states. If lower income drivers are not capable of affording car insurance they face fines and possible imprisonment. Therefore, a fundamental measurement of a healthy and successful insurance pooling mechanism is when the equal opportunity exists for

[18] 2007 only half of Latino households own their own homes compared to more than three-quarters of non-Hispanic Whites. Eric Rodriguez, "Credit-based Insurance Scoring: Why Latinos Pay More for Auto Insurance Than They Should." National Council of La Raza, October 2, 2007, p. 3.

individuals to control the affordability of their car insurance. When mandated, insurance in a society becomes unaffordable and uncontrollable by any portion of the market segment, it is a signal that the system needs correction. Unlike factors such as age, usage, and driving record, which are widely accepted factors that provide equal opportunity for drivers to change, these socio-economic factors are clearly discriminatory against lower and middle income classes and need to be prohibited immediately.

Since the documented proliferation of the use of credit scores as well as these other more damaging rating and underwriting practices, the reported number of uninsured motorist population has continued to grow at an alarming pace.[19] This supports the notion that families at the bottom end of the income scale have very little disposable income, and every dollar spent on premiums for auto insurance represents money that could be spent on other essentials, such as food, shelter and health care. The difficulty lies in the fact that owning a car can be extremely important in terms of finding and holding down a job or providing an opportunity for a person to climb the economic ladder.[20]

In summary, we urge the Federal Legislature to:

- Make effective bans on the use of all rating and underwriting variables that are inherently tied to the income of an individual,
- Prohibit the use of multi-affiliate companies with separate rating structures which have no valid purpose except to adopt these discriminatory practices, and
- Require full disclosure of all rating and underwriting methods to improve transparency to the public

[19] Insurance Information Institute. 2008. “Compulsory Auto/Uninsured Motorists.” http://www.iii.org/media/hottopics/insurance/compulsory (accessed May 18, 2008).

Without these fundamental changes to our industry it is clear that the highest rates for car insurance will be charged to the segment of the population that can least afford it regardless if they commit themselves to responsible driving. Furthermore, such a rating and underwriting practice will only insure those who fall in the highest income scale from receiving the lowest rates. I am hopeful that you see the social injustice that belies this practice and continue to take steps to control such conduct.

At CURE auto insurance we firmly believe in healthy competition in our marketplace however we simply do not believe in competing upon these discriminatory grounds.

Sincerely,

Eric S. Poe, Esq., CPA
Chief Operating Officer
CURE Auto Insurance